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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FILE

In the Matter of: Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes	)	CC Docket No. 92-133

REPLY COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION

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Summary of Contents

A review of the comments shows widespread agreement with the proposals made by USTA. MCI and many others agreed that the Commission should not define cost of equity and other approaches to represcription, and they also agreed with USTA on most procedural options, such as the means for handling discovery. There was little significant opposing comment on Part 65 hearing procedures or enforcement options.

USTA's trigger mechanism is superior to any other. The Commission should reject GSA's proposal for use of 10 year Treasuries (whether once a year in August, as proposed, or at any time) and it also should reject MCI's proposal to conduct a "mini-represcription" within the trigger framework itself. USTA explains why GSA's "data" is not usable here, and rejects "spot rate" options in favor of USTA's moving average.

USTA emphasizes the reasons for using a composite BOC capital structure and cost of debt. Almost all commenters support wide flexibility in cost of equity methods, like USTA. USTA addresses the issue of flotation costs. There is no mechanism for recovery of these costs now, and Part 65 must accommodate them.

Finally, USTA rejects unlimited discovery, for the same reasons as most courts and other agencies, favoring a reasonable balance designed to address identified concerns in the process.

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The United States Telephone Association (USTA) respectfully submits these reply comments in this proceeding, addressing issues raised by the comments of others on the Commission's Notice of Proposed Rulemaking (Notice). Comments were filed by thirty-nine parties, including USTA, by the due date of September 11, 1992.[1]

Two of the areas addressed by USTA - Part 65 hearing procedures and enforcement options - were subject to no significant opposing comment. USTA addresses them at the end of these reply comments and focuses here primarily on issues of substantive methodology.

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[1] Of the commenting parties, many fully endorsed USTA's comments. See, e.g., United Telephone at 9-10; BellSouth at 1; Pacific Bell and Nevada Bell at 1; Southwestern Bell at 1; US West at 3; SNET at 1; Cincinnati Bell at 2; and Alltel at 2.

I. THE TRIGGER MECHANISM SUGGESTED FOR USE BY USTA IS SUPERIOR TO ANY OTHER PROPOSED IN THE COMMENTS AND IS SUPPORTED BY MOST COMMENTERS.

In our comments, USTA proposed a semiautomatic trigger mechanism that would use a six-month moving average of long term Aa public utility bond yields.[2] A change of 150 basis points from a base rate prevailing at the time of the order in this proceeding, that persists for six consecutive months after the completion of this proceeding, would "trigger" Commission review of the need to represcribe the interstate rate of return.[3] Most commenters supported USTA's comments on this issue.[4]

A few commenters offered alternatives or variations on a trigger mechanism that differed from that suggested by USTA. USTA will respond to each in turn.

The General Services Administration (GSA) offered a trigger mechanism that varied from the framework proposed by USTA in a number of respects. GSA proposes the use of 10 year Treasury "bonds", an intermediate term instrument that is ore accurately a note than a bond.[5] USTA proposed long term Aa bonds, and disagrees with the use of a 10 year instrument. 10 year Treasury

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2 USTA comments at 33-34.

3 Id.

4 See footnote 1.

5 GSA at 8-10.

securities cannot be representative of either long term capital costs or of exchange carrier capital costs. Cost of equity, representing the return requirement associated with an investor's ownership interest, is an "infinite period" cost, for which the best surrogate can only be a long term measure.[6] In addition, intermediate instruments are more volatile, and would not offer the same level of confidence and accuracy as long term bonds in the measurement of significant changes in capital markets.

GSA suggests that the 10 year rates be assessed each year, in August.[7] USTA disagrees with this procedure because an annual assessment will perpetuate the very mismatch between the market and the calendar that this proceeding was designed in part to eliminate.[8] A calendar-based rate, reviewed in August (or any month), represents a simple spot rate. It would be indicative of the August rate alone, with all of the accompanying external or seasonal influences. A triggering change that occurred in september or October could not be acted upon for almost a full calendar year, and a transitory change in conditions in August could force action that is unnecessary. Thus, an annual August review would not be either timely or responsive.

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6 The average maturity of bonds in Moody's Aa Public Utility Average is more than 28 years.

7 GSA at 6-8.

8 Notice at ¶¶ 19-20.

GSA's filing shows why its simplistic procedure, tied to the last Commission order, is simply result-oriented.[9] GSA's own data shows why its proposal does not track capital costs; GSA concocts a framework solely to achieve the particular result GSA wants.[10] First, GSA's risk premium data on Attachment 3 is contrived to appear statistically significant, with a constant 4.3 percentage point risk premium assumed to match a lockstep gap between GSA's data and the authorized return. This relationship is false, completely unreliable and thus unusable. Second, if GSA had relied on a true measure of long term capital costs, such as 30 year Treasury bond yields or Aa public utility bond yields, it could not make the claim that capital costs had "fallen sharply" and could not contend that a represcription is now warranted.

MCI Telecommunications Corporation (MCI) agrees with USTA that long term rates should be utilized in any trigger, and its suggested change from a predetermined base point of 200 basis points is not inconsistent with what USTA advocated (for an "automatic" trigger.)[11] However, MCI advocated a review of the current rate only every six months, and it would build a cost of

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9 See GSA at 10, ("clearly", it is time to initiate a proceeding, based on GSA's proposal).

10 GSA at 8-9 and Attachments 1,2.

11 MCI at 5-6.

equity review into the trigger itself.[12] Finally, MCI would also tie the mechanism to the last order of the Commission, rather than having it operate in a prospective fashion.[13]

A review every six months, such as that articulated by MCI, has many of the same "spot rate" problems as that suggested by GSA. USTA explained in its comments why a six month moving average would be superior.[14] The inclusion of a cost of equity methodology in the trigger would impose the same degree of detail and contentiousness in the process of reviewing the need for represcription as exists in represcription itself. USTA's proposed trigger is most consistent with the articulated goals of the Commission and the requirements of the Act. Finally, any recommendation to set the base rate at the time of the last order automatically introduces bias into the trigger. As USTA pointed out, setting the base rate at the time of the order that completes this proceeding focuses on the long term.[15]

Two other commenters also make suggestions concerning the trigger mechanism which merit a response. The Small Business Administration (SBA) advocates a semiautomatic trigger based on the capital costs of companies that are similar to small exchange

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[12] MCI at 6.

[13] Id.

[14] USTA comments at 34-37.

[15] USTA comments at 36-37.

carriers.[16] In this respect, USTA sees SBA as being in agreement with USTA's broader views as to the Notice, though SBA's type of trigger would be unworkable for small exchange carriers. Fred Williamson & Associates (Williamson) suggests the provision of two years of data.[17] Any data provided in the manner suggested by Williamson would be too stale to be useful by the time it becomes available.

USTA's proposal remains the best option for a trigger that is responsive to the market and capable of implementation at reasonable cost and within the structure of the Act.

II. USTA'S CAPITAL STRUCTURE AND COST OF DEBT PROPOSALS SHOULD BE ADOPTED.

USTA proposed a capital structure based on a composite of the Bell Operating Companies (BOCs).[18] The comments overwhelmingly agreed with USTA's proposal. There was only minimal disagreement with this proposal in few comments.

A few parties offered the Regional Bell Holding Companies (RHCs) as capital structure or cost of debt alternatives, and then rather weakly. MCI, Williamson and the National Telephone

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16 SBA at 7.

17 Williamson at 4-5.

18 USTA comments at 57-64.

Cooperative Association (NTCA) each discussed the RHC option.[19] (Williamson focused only on capital structure.) MCI opposed any fixed or binding methodology; it also offered as an alternative a composite of the holding companies of Tier 1 exchange carriers. However, the only firm statement MCI made in this respect was that the Commission should not make any particular capital structure binding.[20] (This is not necessarily inconsistent with what USTA advocated.) NTCA offered the BOC methodology for cost of debt simultaneously with an RHC capital structure, but expressed the need for consistency between cost of debt and capital structure.[21] This leads USTA to conclude that NTCA probably would prefer use of a BOC capital structure, rather than that of the RHCs.

USTA's comments explain in detail the flaws with the use of the capital structures of the RHCs or the holding companies of Tier 1 carriers.[22] MCI's own filing acknowledges that a fixed structure is not appropriate, and MCI's "contingency" - the possibility of an "equity-laden" exchange carrier industry in the future - is remote at best.[23] These RHC-based proposals would

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19 MCI at 28-29; Williamson at 6; NTCA at 4.

20 MCI at 29.

21 NTCA at 5.

22 USTA comments at 58-59.

23 MCI at 30, note 50.

operate in ways that are not going to foster simplification or accuracy.

SBA emphasized the need to use samples that are representative of smaller exchange carriers.[24] It rejects the RHC alternative. USTA believes USTA's own proposal represents the affected rate of return carriers accurately, and thus meets SBA's concerns. Sampling individual small exchange carriers would carry with it all of the burdens, inaccuracies and anomalies that were set out in USTA's comments[25], with no net benefit. USTA examined this option along with other options for the development of the capital structure component of rate of return prescription, and found that a composite of the BOCs was accurate, representative and without undue burden.

Therefore, USTA believes none of these other options should be adopted, and that the USTA proposal on cost of debt and capital structure is the superior option.

III. THE RECORD FULLY SUPPORTS USTA'S COST OF EQUITY PROPOSAL.

USTA's comments explained why it was particularly inappropriate for any new Part 65 rule to include a defined methodology for determining cost of equity.[26] Neither a

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24 SBA at 17.

25 USTA comments at 58-63.

26 USTA comments at 40-42.

presumptive nor a conclusive methodology are merited in this area.[27]

Two commenters suggest that the classic discounted cash flow (DCF) methodology should be included in the rules.[28] In doing so, they fail to explain why the rules should favor this specific alternative, even within the family of DCF methodologies, and they do not address any of the concerns articulated by USTA. Indeed, one of the commenters, MCI, is in some respects consistent with the view expressed by USTA. While MCI suggests a "classic" DCF analysis should be provided, it nevertheless opposes any presumptive methodology, and it further rejects the need for codification in Part 65 of any cost of equity methodology.[29] Like USTA and the vast majority of other commenters, MCI recognizes that it cannot be determined in advance what the most accurate cost of equity methodology should be in a particular circumstance.

GSA and SBA are far afield from all other commenters on this issue, and also far apart from each other. GSA seeks

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27 Commenters who suggested that participants in a represcription proceeding should be able to submit data based on any recognized methodology included United Telephone at 4; Bell Atlantic at 3; Southwestern Bell at 2; SNET at 5, and a host of small exchange carriers.

28 MCI at 24-26; GSA at 12.

29 MCI at 24.

codification of DCF using the RHCs as surrogates for providers of interstate access; however, as explained above, GSA's comments are palpably outcome-determinative. They are fundamentally at odds with all other commenters, and fail to justify any need for cost of equity codification. In contrast, SBA seeks options that match small company costs of equity and resources.[30] The specific suggestions made by SBA, however, are unworkable. A prominent benefit of the suggestions made in USTA's comments on cost of equity is that flexibility and the opportunity to choose a methodology appropriate to the circumstance would best provide for calculating the cost of equity of the affected carriers, and would do so in a reasonably workable and accurate manner. In contrast, the data contemplated by SBA would be difficult to find and would be unusable across the non-price cap universe of exchange carriers.

There is a cost of equity issue raised in the comments, however, that bears attention and more detailed discussion. Both MCI and Williamson address the issue of flotation costs, and suggest these costs are not relevant to determining the cost of equity for exchange carriers.[31] USTA strongly disagrees. The Commission would violate basic principles in the represcription process by failing to accommodate flotation costs in Part 65.

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[30] SBA at 13, 15.

[31] <u>See</u>, <u>e.g.</u>, MCI at 26.

Flotation costs are a direct cost that must be considered in calculating the cost of equity. They have an impact on the actual equity proceeds received by the carrier.[32] Yet, there is no mechanism currently in place for the recovery of these costs. The Commission has not been consistent in its handling of flotation costs. It allowed recovery of those costs at one time in the past, but more recently has simply elected to ignore them in the represcription process. USTA believes the Commission may not fully understand that these costs have a continuing impact on carriers' cost of equity. The Part 65 rules must accommodate these costs, just as they must accommodate other costs.[33]

IV. THE STATUTORY SCHEME PROHIBITS THE AUTOMATIC REFUND MECHANISM SOUGHT BY MCI.

USTA, Rochester Telephone and Central Telephone provided thorough and consistent analyses of the current law on refunds

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[32] USTA has taken data on the DCF cost of equity that were provided to the Commission in response to the Bureau's data request in the last rate of return proceeding, Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, and has compiled information on the actual flotation costs experienced by the firms listed in that date request, as well as many others affecting exchange carriers. The data indicate that the average level of flotation costs is around 4%. USTA is prepared to discuss the role of flotation costs and the costs experienced by individual companies in equity offerings in more detail with Commission staff.

[33] See, Illinois Bell v. FCC, 911 F.2d 776, (D.C. Cir. 1990).

under the Act.[34] No other commenter addressed this issue with any degree of research into the controlling cases. As an illustration, MCI articulated a generalized argument that the Commission should simply reinstitute its original automatic refund rule.[35] Of course, the Commission has already had that rule invalidated, and it would be unlawful to pursue a rule that has already been found defective.

Because Part 65 will govern only rate of return represcription, there should be nothing in this proceeding to impact carriers operating under price cap regulation. The Notice suggested no ramification on those carriers, nor did it ask for comment on changes in price cap regulation, including changes in the sharing zones.

Further, no one offered a compelling reason to burden exchange carriers with any extensive earnings monitoring procedure. If the Commission elects to utilize any monitoring scheme, it should cover a period of no less than two years.[36]

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[34] USTA comments at 71-75; Rochester at 32-41; Central Telephone at 17-30.

[35] MCI at 30.

[36] Both USTA and NECA agreed that the earnings buffer for carriers should be 100 basis points. See NECA at 12-14.

The Commission should take action in this area that is consistent with USTA's comments.

V. THE COMMUNICATIONS ACT CONTROLS THE PROCEDURAL PROCESS TO BE IMPLEMENTED.

USTA's comments opposed the proposal in the Notice that Part 65 represcription become a simple notice-and-comment proceeding.[37] However, USTA (and Rochester) provided a range of suggestions as to how the Part 65 procedures could be streamlined to achieve greater efficiency and simplification, yet still comply with the structure of the Act.

The Commission is bound by the Act and the courts' interpretation of it. A notice-and-comment arrangement is seductive because it permits the Commission to ease its own burdens by omitting or skipping the types of safeguarding procedures that now exist, and that may add a degree of additional work to the represcription process. However, the benefits of these additional steps are well worth the effort, as they protect carriers and the Commission from nonsubstantive influences and best assure the overall integrity of the represcription process.

Finally, discovery issues were the subject of only a few comments. MCI raised a seemingly small issue in advocating

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[37] USTA comments at 6-19. See also the extended discussion in comments of Rochester at 5-14.

expansive discovery - potentially every scrap of paper.[38] This is not a small issue, however. USTA believes that the public interest would be better served by utilizing the discovery alternative described by USTA in its comments, and leaving open the option that further discovery may be merited and later permitted.[39] Indeed, MCI appears to agree with much of USTA's comments on discovery.[40] USTA's alternative would limit discovery abuse, unreasonable burdens, and cost, but would be targeted to the information that an adversary on the issue of rate of return would seek.

Respectfully submitted,

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October 13, 1992

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38 MCI at 17.

39 USTA comments at 28-31.

40 MCI at 19-22.

CERTIFICATE OF SERVICE

I, Stephanie Kantor, do certify that on October 13, 1992 copies of the foregoing Reply Comments of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

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